



---

Corporate Tax Department  
4333 Edgewood Road NE, MS 3210  
Cedar Rapids, IA 52499  
Phone 319-398-8596  
Fax 319-369-2226

August 19, 2005

Senator Charles Grassley, Chairman  
Senator Max Baucus, Ranking Member  
Committee on Finance  
United States Senate  
219 Dirksen Senate Office Building  
Washington, DC 20510

Dear Chairman Grassley and Ranking Member Baucus:

On behalf of AEGON USA, I am writing to comment on the proposed legislation to make technical changes in the tax code, S. 1447, the *Tax Technical Corrections Act of 2005*. I appreciate the opportunity to raise the following points with the Finance Committee about the potential inclusion of an additional technical correction related to the identified straddle amendments included in H.R. 4520, the *American Jobs Creation Act of 2004 (the "Act")*.

The specific concern with this provision is that it could be interpreted so as to result in a permanent disallowance of a loss rather than a loss deferral. In addition, there is some question as to the effectiveness of the provision prior to the promulgation of guidance by the Secretary. Based on discussions with the staff of the Finance Committee, Ways and Means Committee, and Joint Committee of Taxation, as well as with Treasury Department personnel, it does not appear that the intent of the new provision was to eliminate losses altogether or to delay the effective date of the new rules until regulations are issued. As a result, we ask you to consider making technical corrections to this provision to ensure it operates as intended.

### **Background**

Included in the Act was a provision revising the existing rules on straddles, including a reform that was viewed as simplifying the law for so-called identified straddles. To avoid abuses, the general straddle rules require a taxpayer to defer losses incurred until gains in offsetting positions are realized. Previous law provided an exception to this rule for certain identified straddles. The new statutory language replaced this exception with a basis adjustment rule and appeared to provide more flexibility for taxpayers to use identified straddles. This new provision is of interest to AEGON USA and other insurers because, as insurance companies, we are in the business of managing risks, including investment risks. We frequently enter into offsetting positions in the ordinary course of our business to conservatively manage such risks. As a result,

we have transactions that could be subject to the general straddle rules, absent the ability to use alternatives such as identified straddles.<sup>1</sup>

The legislation passed last year was initially viewed by us and others in the insurance industry as a welcome clarification and simplification of the identified straddle rules. Unfortunately, recent comments by Treasury and IRS personnel have suggested an interpretation outside the apparent intent of Congress. As noted above, their interpretation is that the new statutory language might result in the permanent denial of a loss, rather than loss deferral. Such a dramatic change in the straddle rules is not discussed in any of the legislative history, nor does it fit with the simplification and clarification theme of the provision.

Moreover, taxpayers who wish to use the identified straddle regime need clarification that, until the Treasury Department issues regulations, they may use reasonable methods to identify straddles. Congress enacted the new identified straddle rules effective October 22, 2004, and taxpayers should not be forced to wait for Treasury to issue regulations before being able to utilize the new rules.

It seems that these two issues should appropriately be addressed in a technical corrections bill to ensure that the provision operates as intended.

### **Identified Straddle Exception – Losses in Excess of Unrecognized Gains**

The tax straddle rules (IRC section 1092) generally require taxpayers to defer realized losses on a straddle position to the extent the taxpayer has unrecognized gains on offsetting straddle positions. Losses in excess of unrecognized gains, however, are not limited by the straddle rules. In addition, losses that are deferred under the straddle rules can be carried forward indefinitely and become available to the taxpayer in a future year to the extent such deferred losses exceed unrecognized gains on offsetting straddle positions. This can occur, for example, when gains on an offsetting straddle position are recognized upon a subsequent sale of the offsetting position.

Although the basic goal of the straddle rules can be easily described, application of the rules can be problematic. The straddle rules are written in a manner that assumes that the offsetting positions in a tax straddle are readily determinable. While this may be true for an investor with a limited number of positions, determining the positions that make up a tax straddle is a difficult and uncertain proposition for a taxpayer, such as an insurance company, holding and managing a large investment portfolio in the ordinary course of its business. When the tax straddle rules were originally enacted in 1981, Congress directed the Secretary to promulgate guidance providing a method to be used by taxpayers in the determination of the positions making up a tax straddle. No such guidance, however, was ever provided by the Secretary.

---

<sup>1</sup> There are other potential exceptions to the straddle rules, such as the tax hedging rules of IRC section 1221(a)(7) or other hedging provisions (Treas. Reg. section 1.988-5 and Treas. Reg. section 1.1275-6). However, these hedging exceptions are narrowly drawn and are not always available to an insurance company with a large, actively managed investment portfolio.

Section 888 of the Act significantly extended the availability of the prior law exception for qualifying “identified straddles.” The amendments made by the Act reflect Congress’ frustration with the failure of the Secretary to provide required guidance on the application of the straddle rules to “unbalanced” straddle positions, which the Secretary had been instructed to provide under the original straddle legislation adopted in 1981.<sup>2</sup>

Under the new “identified straddle” rules, taxpayers are allowed to identify the offsetting positions making up the straddle. The positions making up an identified straddle are then excepted from the general straddle loss deferral rules, and are instead subject to the special rules for identified straddles. The identified straddle rules are important in providing taxpayers some certainty over the positions making up a tax straddle, thereby precluding such identified positions from being arbitrarily considered a tax straddle with respect to other positions on an after-the-fact basis.

In addition to exempting the offsetting positions of an identified straddle from the general straddle loss deferral rules, the new identified straddle rules also provide that realized losses from any position included in an identified straddle are added to the tax basis of those offsetting identified positions with “unrecognized gain,” but only to the extent of the amount of such unrecognized gain. For purposes of the identified straddle rules, “unrecognized gain” is defined as the excess (if any) of (1) the fair market value of a position as of the date a loss on an offsetting position in the identified straddle is realized (the “determination date”) over (2) the fair market value of the position on the date the identified straddle was entered into. Realized losses that are added to the tax basis of an offsetting identified straddle position are essentially deferred until the offsetting position is subsequently disposed of. Losses in excess of “unrecognized gains” are exempt from the straddle rules.

Notwithstanding what appears to be clear Congressional intent to provide an exception to the straddle rules for qualifying identified straddles, the amendments made by the Act could be construed in a manner that would permanently disallow realized losses on offsetting positions in

---

<sup>2</sup> In 2001, in a study of simplification alternatives for the tax code, the Joint Committee on Taxation proposed several changes to the straddle rules including what we believe is the first version of a proposal to statutorily clarify the identified straddle regime; a proposal that was ultimately enacted as Section 888 of the *American Jobs Creation Act of 2004* (P.L. 108-357). In the discussion by the Joint Committee on Taxation, the staff noted that the Treasury Department had not issued regulations since 1981, when Congress had directed Treasury to issue regulations related to identified straddles and unbalanced straddles. The staff recommended a new identification regime as well as a capitalization regime that ultimately was included in the *American Jobs Creation Act of 2004* (Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-02), pp. 339-342).

an identified straddle. Specifically, IRC section 1092(a)(2)(A)(ii) requires that the tax basis of each of the identified offsetting positions in the identified straddle be increased “by an amount that bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions.” IRC section 1092(a)(2)(A)(iii) then states that “any loss described in clause (ii) *shall not otherwise be taken into account* for purposes of this title.” (*Emphasis added.*)

It seems clear that the “not otherwise taken into account” reference in IRC section 1092(a)(2)(A)(iii) was simply intended to prevent taxpayers from attempting to “double dip” or utilize the same loss twice. In other words, to the extent any portion of a realized loss is added to the tax basis of an offsetting position included in an identified straddle, that portion of the loss would not otherwise be deductible. The legislative history to the Act confirms this intent by stating that any loss with respect to an identified position that is part of an identified straddle “cannot otherwise be taken into account by the taxpayer or any other person *to the extent that the loss increases the basis of any identified positions that offset the loss position* in the identified straddle.” (*Emphasis added.*)

Notwithstanding this logical interpretation, some Administration personnel have publicly stated that the modified identified straddle rules can be interpreted to cause permanent denial of a portion of a taxpayer’s realized losses on positions included in an identified straddle – a result that is contrary to both the normal straddle loss deferral rules, as well as to the exception provided for qualifying identified straddles. If such an interpretation were correct, the modified identified straddle rules would actually result in a dramatic shift in policy from deferring losses to permanently denying losses. This would mean that an amendment that was intended to provide taxpayers with relief from the general straddle rules would instead result in identified straddles being subjected to more onerous rules. This potential interpretation of the identified straddle rules, however remote, makes the modified identified straddle rules a potential tax trap.

Technical corrections to the amended identified straddle rules are necessary to make it clear that realized losses resulting from an offsetting position in an identified straddle that exceed unrecognized gains on other positions included in the identified straddle do not disappear, but are available in the year realized.

### **Example of Losses in Excess of Unrecognized Gains**

Because a straddle involves “offsetting positions,” one might wonder why a loss on one position would not be offset by unrecognized gain in the other position. It is possible, however, for an identified straddle to have a result in which there is no unrecognized gain on an offsetting position. Such a result may occur, for example, when an unrelated risk that is not offset causes the value in the offsetting position to decrease.

For example:

In the ordinary course of its business, an insurance company buys a corporate bond for \$95 to back its insurance liabilities. Because the company is concerned that interest rates will rise, it also enters into an interest rate swap to hedge this risk. Assume that the

company properly and timely identified the bond and the swap as the positions making up an “identified straddle” under new IRC §1092(a)(2).

If interest rates rise, the bond market value may drop to \$92, but the swap will be worth \$3. If interest rates fall, the bond market value may increase to \$97, but the swap will be worth (\$2). In both situations, the company is economically in the same position. If the swap were to be sold in the first instance, a \$3 gain would be recognized. Under the new identified straddle rule, if the swap were to be sold in the second instance, the basis of the bond would be increased by the \$2 realized loss on the swap.

However, assume that interest rates fall as in the second scenario and that the bond’s credit rating also is downgraded. Assume that as a result of these events, the bond’s market value falls to \$80, while the swap value is (\$2). If the swap were to be sold in this situation, the treatment of the \$2 realized loss is not clear under the new statutory language because the loss exceeds the amount of unrecognized gain (which is \$0) on the offsetting position.

Under the Administration’s potential interpretation of the new identified straddle language, the taxpayer in the above example would be permanently denied the \$2 true economic loss on the swap if there is not an equal amount of unrecognized gain on the offsetting bond. It appears obvious that this result is not appropriate and was not intended as part of the amendments to IRC § 1092(a)(2).

### **Technical Correction Needed**

Our concerns about the identified straddle language result from public comments made by both Treasury and IRS officials who have stated that a literal interpretation of the new language could result in loss denial rather than loss deferral. One of the same Treasury officials also indicated that clarifying the operation of this provision might not be possible by way of regulations, noting that “[f]rankly I don’t know how we in the administration would correct that.” (“Officials Cite Problems with Changes to the Straddle Rules,” Tax Notes, June 6, 2005, p. 1229-30). The clear implication is that the statute must be corrected by a technical correction.

Representatives from AEGON USA have met with the Joint Committee on Taxation and the respective staffs of the tax writing committees. At this stage, no one has suggested that Congress had intended (in the straddle language adopted) to deny losses completely. The legislative history does not suggest such an outcome either. As such, we believe that this issue is appropriate for a technical correction to clarify the application of the new identified straddle provision in cases where losses from an identified straddle position exceed unrecognized gains on identified offsetting positions.

The legislative history clearly supports the conclusion that Congress did not intend to deny losses as is illustrated in the example above. Further, as noted above, the relevant legislative history indicates that losses in excess of unrecognized gains may be taken immediately, by stating that “Any loss with respect to an identified position that is part of an identified straddle cannot

otherwise be taken into account by the taxpayer or any other person *to the extent that the loss increases the basis of any identified positions that offset the loss position in the identified straddle.*” (H. Rpt 108-755, American Jobs Creation Act of 2004, Conference Report to Accompany H.R. 4520, pp. 756-57) (emphasis added). To the extent the losses in the example set out above do not increase the basis of any identified offsetting positions in the straddle, the reasonable interpretation of the new statutory language and the relevant legislative history is that the taxpayer should be able to immediately deduct such a loss. This legislative history is repeated in the Blue Book for the 108<sup>th</sup> Congress. (Joint Committee on Taxation, “General Explanation of Tax Legislation Enacted in the 108th Congress” (JCS-5-05), May 2005, p. 484).

### **Identified Straddle Exception -- Effectiveness**

Finally, Treasury officials have also suggested that the new identified straddle provisions do not take effect unless and until the Secretary prescribes regulations specifying, among other items, the proper methods for clearly identifying a straddle as part of an identified straddle.

The Administration’s suggestion that the new identified straddle rules are not effective unless and until regulations are promulgated by the Secretary does not appear to have any support in the statute itself or the accompanying legislative history. This interpretation also seems wholly inconsistent with the rationale for amending IRC section 1092(a)(2) itself, namely the failure of the Secretary to have prescribed regulations pursuant to the 1981 legislative mandate obligating the Secretary to establish guidance for unbalanced straddle positions.

The Joint Committee on Taxation, in explaining the reasons why the identified straddle rules were changed, states “While the prior-law rules provided authority for the Secretary to issue guidance concerning unbalanced straddles, the Congress was of the view that such guidance was not forthcoming. Therefore, the Congress believed that it was necessary to provide such guidance by statute.” (Joint Committee on Taxation, “General Explanation of Tax Legislation Enacted in the 108th Congress” (JCS-5-05), May 2005, p. 483). In fact, Treasury has had the opportunity to issue regulations for nearly 23 years, and it has chosen not to do so. It may take significant time for any such future guidance from Treasury. The statute’s language, on its face, applies to positions established on or after October 22, 2004. Therefore, we suggest a technical correction making it clear that a taxpayer can use a reasonable method to identify the positions making up an “identified straddle” until such time as the Treasury issues regulations under IRC Section 1092(a)(2).

### **Proposed Technical Corrections**

We respectfully submit the attached technical correction language as a proposal that would ensure that the new identified straddle provision operates as intended and cannot be interpreted to permanently deny realized losses that exceed unrecognized gains.

The suggested language in subclause I is drawn directly from the legislative history. (See, e.g., H. Rpt. 108-755, American Jobs Creation Act of 2004, Conference Report to Accompany H.R. 4520, p. 756). We believe this approach – which confirms that losses from identified straddle

positions that exceed unrecognized gains on offsetting positions are available in the year realized – is supported by the legislative history and a fair reading of the statute.

Alternatively if the Committee determines that the intent of the modified identified straddle rules was to parallel the general straddle loss deferral rule, a second option would be to capitalize all losses realized on positions included in an identified straddle, not just losses up to the amount of “unrecognized gain” on offsetting positions. We could support an interpretation that requires capitalization of the full amount of realized losses on positions included in an identified straddle since this alternative would at least provide taxpayers with assurances as to the positions making up a tax straddle. This clarification would in and of itself be valuable in that it would provide taxpayers with certainty as to the operation of the straddle rules and, as a result of the basis adjustments to offsetting positions, the time at which losses would eventually be made available. The attached proposed technical correction does not reflect such a broad policy change and, if this approach were adopted, further revisions to the proposed technical correction to IRC section 1092(a)(2) would be required.

We also suggest a clarification to explicitly allow taxpayers to use any reasonable method to identify straddles unless and until the Treasury issues regulations.

### **Conclusion**

Thank you for the opportunity to comment on the S. 1447, the *Tax Technical Corrections Act of 2005*. I hope you will look favorably on including the requested technical corrections in the legislation.

Sincerely,  
AEGON USA, Inc.

A handwritten signature in cursive script, reading "Arthur C. Schneider".

Arthur C. Schneider  
Senior Vice President and Chief Tax Officer

Internal Revenue Code

§ 1092 Straddles.

(a) Recognition of loss in case of straddles, etc.

(2) Special rule for identified straddles.

(A) In general. In the case of any straddle which is an identified straddle—

(i) paragraph (1) shall not apply with respect to identified positions comprising the identified straddle,

(ii) if there is any realized loss for any taxable year with respect to any identified position of the identified straddle,

(I) such loss shall be taken into account to the extent that the amount of such loss exceeds the unrecognized gain (if any) in any identified offsetting positions.

(II) the basis of each of the identified offsetting positions in the identified straddle which have an unrecognized gain shall be increased by an amount of the loss not taken into account in subclause (I), which bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions, and

(III) the amount of any loss which increases basis under subclause (II) shall not otherwise be taken into account for purposes of this title.

Formatted: Font color: Red

Deleted: ,

Deleted: -

Formatted: Indent: Left: 2.25", Hanging: 0.25"

Formatted: Indent: Left: 2.25", Hanging: 0.25", Adjust space between Latin and Asian text, Adjust space between Asian text and numbers

Formatted: No underline, Font color: Auto

Deleted: (iii) any loss described in clause (ii) shall not otherwise be taken into account for purposes of this title.¶

(B) Identified straddle. The term "identified straddle" means any straddle—

(i) which is clearly identified on the taxpayer's records as an identified straddle before the earlier of—

(I) the close of the day on which the straddle is acquired, or

(II) such time as the Secretary may prescribe by regulations.

(ii) to the extent provided by regulations, the value of each position of which (in the hands of the taxpayer immediately before the creation of the straddle) is not less than the basis of such position in the hands of the taxpayer at the time the straddle is created, and



(iii) which is not part of a larger straddle.

The Secretary shall prescribe regulations which specify the proper methods for clearly identifying a straddle as an identified straddle (and the positions comprising such straddle), which specify the rules for the application of this section for a taxpayer which fails to properly identify the positions of an identified straddle, and which specify the ordering rules in cases where a taxpayer disposes of less than an entire position which is part of an identified straddle. Until such time as the Secretary issues such regulations, a taxpayer may use any reasonable identification method.